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Paul Hastings SEC Update

SEC Adopts Rules Enhancing Short Sale Disclosures

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On October 13, 2023, the U.S. Securities and Exchange Commission (the "SEC") adopted final rules requiring the reporting and disclosure of short sale trade data information.[1] New Rule 13f-2 implements new obligations on certain institutional investment managers ("Managers") to report short position and activity data for certain equity securities on new Form SHO. The SEC also amended the national market system plan governing the consolidated audit trail ("CAT NMS Plan") relating to disclosure of short sales made under the bona fide marketing exception. The SEC promulgated the new rules pursuant to its statutory mandate under Section 929X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to increase transparency of information relating to short selling, including data which may indicate abusive naked short selling, which is prohibited under Regulation SHO. Together, the new rules may provide public companies with greater protection against activist short-sale attacks by providing more real-time information regarding Manager's short positions and by uncovering and discouraging naked short selling.

Short Selling and Regulation SHO

A short sale is a sale of a security that the seller does not own. The short seller effectuates the sale by borrowing a security to deliver to the buyer and later acquiring the security on the open market prior to the due date of the loaned security. Short sales allow sellers to profit from an expected decline in the security's value.

In recent years, short selling has attracted the SEC's significant attention, given recent volatility in the securities markets, high profile short attacks by activist shareholders, and increased visibility into short selling among the investing public. One widely covered example includes the retail investor-led short squeezes in shares of companies such as GameStop and AMC. In 2023, Congress published reporting on the benefits and concerns presented by short selling, referencing the 2021 GameStop short squeeze as a case study.[2] Short selling itself is not prohibited. As SEC Commissioner Mark T. Uyeda observed in public remarks on October 13, 2023, "Short sales can play a vitally important role in setting a fair price for

[1] Short Position and Short Activity Reporting by Institutional Investment Managers, Exchange Act Release No. 34-98738, (adopted Oct. 13, 2023) https://www.sec.gov/files/rules/final/2023/34-98738.pdf.
[2] *See* Congressional Research Service, *Short Selling: Background and Policy Issues*, (Aug. 8, 2023) *available at* https://crsreports.congress.gov/product/pdf/IF/IF12400.

securities, which is perhaps the greatest protection for investors in the market."[3] Commissioner Uyeda went on to acknowledge that the SEC recognizes there is a risk that abusive short selling practices nevertheless can create undesirable market manipulation.

One such practice involves when a short seller initiates a short sale without first borrowing the stock or locating a source from which the stock can be borrowed—a process known as "naked short selling." Naked short selling is problematic because it allows bad actors to sell shares that are not presently available and then spread false information in order to depress the share price and profit from covering their short position after the fact at the artificially lowered price. Naked short selling also may trigger a failure to deliver, where a seller is unable to deliver the sales it has sold when due because it is unable to procure them.

The SEC explicitly has prohibited abusive naked short selling since 2005, when it implemented a number of significant changes relating to short sale practices through Regulation SHO. Among other requirements, Regulation SHO implemented a uniform "locate" requirement requiring broker-dealers to "locate" a security prior to selling it, either by borrowing the share itself or having "reasonable grounds" to believe the security can be borrowed.[4] The regulation contains a number of exceptions, including for short sales executed by market makers or share sale orders from other broker-dealers who themselves are subject to the locate requirement.

Abusive naked short selling can be difficult to detect because it requires a necessarily speculative analysis of false information publicly disseminated about an issuer, or access to proprietary information typically available only to the broker-dealers themselves, such as data on a Manager's gross short position or share trade activity, including trades in options.

New Reporting Requirements and SEC Publication

Rule 13f-2 increases transparency around short sale data and facilitates publication of information which may indicate abusive naked short selling in two ways. First, Rule 13f-2 requires Managers meeting or exceeding reporting thresholds to report to the SEC on new Form SHO certain short position and equity trading data for equity securities. Second, it requires the SEC to anonymously aggregate and publish certain data through EDGAR.

Rule 13f-2's reporting requirements apply to Managers that meet or exceed certain reporting thresholds, which differ based on whether the subject equity security is of an issuer reporting pursuant to Section 12 or Section 15(d) of the Securities Exchange Act of 1934 or a non-issuer. The threshold is met when a Manager's short position in a particular equity security is:

- For shares of issuers, greater than or equal to $10 million or the equivalent of 2.5 percent or more of total average shares outstanding throughout a month; or
- For shares of non-issuers, $500,000 on any given settlement day during the month.

For each subject equity security, Managers will be required to report on Form SHO the end-of-month gross short position and, for each individual settlement date, the Manager's net activity, including derivatives.

In promulgating Rule 13f-2, the SEC recognized that the new reporting requirement often involves data that, on an individual basis, is proprietary to the reporting parties. Accordingly, the SEC will anonymously

[3] Mark T. Uyeda, *Statement on Short Position and Short Activity Reporting by Institutional Investment Managers* (Oct. 13, 2023) ***available at*** https://www.sec.gov/news/statement/uyeda-statement-short-sale-101323.
[4] Regulation SHO Rule 203(b)(1).

aggregate reported data by security across all Managers prior to publishing the data through EDGAR within four weeks after the end of each month.

Ultimately, the reporting and publishing of short position and short activity data will grant the SEC and the investing public increased visibility into short sale transactions, including data which may indicate abusive naked short selling. Further, as SEC Chair Gary Gensler mentioned in public comments on October 13, 2023, the final rules address the SEC's finding in its Report on Equity and Options Market Structure Conditions in Early 2021, commonly known as the GameStop Report, that improved reporting of short sale data would better allow regulators to better track the interplay of shorting and price dynamics.[5]

Amendment to the CAT NMS Plan

The CAT NMS Plan tracks sale orders of eligible securities throughout their lifecycle and identifies the broker-dealers handling those orders. The SEC now will require each CAT reporting firm to disclose when asserting the bona fide marketing exception under Rule 203(b)(2)(iii) of Regulation SHO in relation to a short sale.

Costs and Benefits

The SEC's 3-2 vote among party lines reflected significant debate among the Commissioners with respect to the new rules. The debate largely focused on the fact that although the new rules may benefit the markets through increased transparency of short sale data, they present costs in the form of potentially burdensome reporting and compliance obligations. In support of the rule, SEC Chair Gensler explained that the rulemaking fulfills the SEC's congressional mandate following the 2008 financial crisis "to enhance transparency of short selling." SEC Commissioner Jaime Lizárraga opined that the new rules increase transparency, enhance market oversight, and reduce systematic risk from large, short sale positions.[6] In opposition, Commissioner Hester Peirce stated that the new reporting requirement "does not adequately consider all the costs associated with its implementation" and involves reporting of information that may not contain significant regulatory value but is nevertheless "highly sensitive."[7] Commissioner Uyeda and Commissioner Peirce also questioned whether regular reporting of short sale data not specifically enumerated in the Dodd-Frank Act exceeded the SEC's congressional mandate.

Timing

The rule will be effective 60 days after publication of the adopting release in the Federal Register. The public compliance date for Rule 13f-2 and Form SHO will be 12 months following the effective date. The SEC will begin making public aggregated reporting data via EDGAR three months later. Public compliance with the amendment to the CAT NMS plan will be 18 months following the effective date.

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[5] ***See*** Gary Gensler, *Statement on Final Rules Regarding Short Sale Activity*, (Oct. 13, 2023) ***available at*** https://www.sec.gov/news/statement/gensler-statement-short-sale-101323.
[6] ***See*** Jaime Lizárraga, *Short Sale Disclosure: Striking the Right Balance*, (Oct. 13, 2023) ***available at*** https://www.sec.gov/news/statement/lizarraga-statement-short-sale-101323.
[7] ***See*** Hester M. Peirce, *Statement on Short Sale Disclosure*, (Oct. 13, 2023) ***available at*** https://www.sec.gov/news/statement/peirce-statement-short-sale-101323.

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